Fiscal Note

BILL # HB 2003 **TITLE:** corporate income tax; rates

SPONSOR: Livingston **STATUS:** As Introduced

PREPARED BY: Hans Olofsson

Description

The bill, as introduced, would reduce the Corporate Income Tax (CIT) rate from the current rate of 4.9% to 4.0% in Tax Year (TY) 2023, 3.5% in TY 2024, 3.0% in TY 2025, and 2.5%, beginning in TY 2026.

Estimated Impact

Based on a set of critical assumptions and caveats, which are discussed in more detail in the *Analysis* section below, we estimate that phasing down the CIT rate from 4.9% to 2.5% over 4 years, beginning in TY 2023, would result in a General Fund revenue reduction of $(223.4) million in FY 2024, $(365.9) million in FY 2025, $(523.8) million in FY 2026, and $(668.9) million in FY 2027, as shown in *Table 1* below.

Table 1

4-Year Phase-In of 2.5% Corporate Income Tax Rate
Revenue Impact [$ Millions]

Tax Year / Fiscal Year	Tax Rate	Revenue Impact
TY 2023/FY 2024	4.0%	$(223.4)
TY 2024/FY 2025	3.5%	$(365.9)
TY 2025/FY 2026	3.0%	$(523.8)
TY 2026/FY 2027	2.5%	$(668.9)

Analysis

The revenue impact of the proposed CIT rate reductions listed in the *Estimated Impact* section are highly speculative due to a couple of factors that we have outlined below. For this reason, our estimates must be interpreted with caution.

Factor 1: Volatility of CIT Collections
Our analysis of the proposed CIT rate reduction is based on the projected level of CIT collections through FY 2026 under the updated October 4-sector forecast. For FY 2027, we assumed that CIT would increase by 1.1% over the projected FY 2026 level, which is based on the average annual growth rate in the most recent 15 years. We would note, however, that Arizona may be at a high point in terms of the current level of CIT collections. CIT is a very cyclical revenue source where collections can fluctuate considerably over time.

To provide some perspective, CIT grew by 127% in the last two fiscal years (from FY 2020 to FY 2022), while it declined by (58)% in the period from FY 2007 to FY 2010. Therefore, if CIT continues its cyclical pattern, the October 4-sector CIT baseline forecast (on which are estimate is based on) may be overstated.

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Factor 2: Timing of Revenue Impact from CIT Rate Reductions
The time periods when corporations are required to make their quarterly estimated payments, file their annual tax return as well as their extension return vary widely. The reason for this is that a corporation's fiscal year is often different from the calendar year. As a result, a corporation's tax year often includes a 12-month period other than from January to December. For example, a corporation whose fiscal year runs from May 1, 2022 to April 30, 2023 would not be required to file its 2022 Tax Return until August 15, 2023, which coincides with the 2024 state fiscal year.

One of the implications of such staggered 12-months periods for corporations is that the impact of the proposed rate reduction in any of the tax years could occur across 4 different state fiscal years. Therefore, to ensure that we do not underestimate the dollar value of the tax reduction in the early years, we have assumed that the rate reduction occurs entirely in the fiscal year following the tax year. This means that under the bill's 4-year phase-in of the 2.5% CIT rate, which starts in TY 2023, we have assumed that the full revenue impact of the first rate reduction (from 4.9% to 4.0%) would occur in FY 2024. However, the actual revenue impact of the first-year phase-in of the rate reduction could start as early as in FY 2023 and end as late as in FY 2026. We are not aware, however, of data that would allow us to project the corporate taxpaying calendar with any accuracy.

Finally, we would note that the estimates above do not reflect the potential behavioral response of taxpayers to the changes under the proposed CIT rate reduction. For example, all else equal, a reduction of corporate income taxes can serve as an incentive for businesses to invest in more capital and hire more labor than they would otherwise. Such "dynamic" effects may result in an increase in economic output, which in turn may generate more tax revenue dollars for the state General Fund than what a "static" analysis assumes.

Local Government Impact

Beginning in FY 2024, incorporated cities and towns receive 18% of individual and corporate income tax collections from 2 years prior from the Urban Revenue Sharing (URS) Fund established by A.R.S. § 43-206. Therefore, under the bill, URS distributions to cities and towns would decrease by $(40.2) million in FY 2026, $(65.9) million in FY 2027, $(94.3) million in FY 2028, and $(120.4) million in FY 2029.

1/9/23